



## TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

### LEGISLATIVE PROPOSAL (T&E-2006-12): AMENDMENTS TO UNIFORM PRINCIPAL & INCOME ACT

TO: Larry Doyle, Chief Legislative Counsel, State Bar Office of Governmental Affairs

FROM: Barry Fitzpatrick, Chair, Trusts and Estates Executive Committee  
W. F. Docker, Chair, Trust and Estate Administration Subcommittee  
Richard Burger, Member, Trusts and Estates Executive Committee

RE: Project No. 2005-04  
Amendments to the Uniform Principal and Income Act.  
An act to amend §§16340, 16361, 16363, and 16354 of, and to add new §16374.1 to, Chapter 3 of Part 4 of Division 9 of the California Probate Code

#### SECTION CONTACTS:

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**DIGEST:** In January of 2000, California adopted the Uniform Principal and Income Act (the "UPIA") through the enactment of AB 846 (Ackerman), Chapter 145, Statutes of 1999. The UPIA was designed to update the law to reflect new estate planning practices and financial instruments, as well as to make principal and income rules consistent with the prudent investor rule embodied in the Uniform Prudent Investor Act. The UPIA was based upon the 1997 Uniform Principal and Income Act adopted by the National Conference of Commissioners on Uniform State Laws (the "Uniform Act").

These proposals are intended to correct some drafting errors – and also to remedy some perceived flaws – in the UPIA.

Included is a proposed default "ordering" rule for distributions from private trusts. The rule sets forth a default order of the character of distributions of distributable net income from a trust to its beneficiaries.

Also proposed is a rule which will make the obligation to pay interest on pecuniary bequests from trusts identical to that which governs pecuniary bequests in wills. This is intended to correct a drafting error in the UPIA.

A grandfathering provision for the allocation of distributions received by a trust from natural resources is also included. This provision was inadvertently omitted from the UPIA.

Finally, a significant change in the treatment of distributions from individual retirement accounts is proposed.

#### **PURPOSE:**

##### Probate Code §16340

When Probate Code §16340 was adopted, former §16314, which governed the payment of interest on pecuniary devises from trusts (applying the same rule as that for wills) was repealed. The drafters of §16340 apparently intended to include all of the essential rules from former §16314 that were repealed, but §16340 did not contain an explicit requirement to pay interest on pecuniary devises. This proposal is designed to cure that oversight.

##### Probate Code §§16363, 16364

Probate Code §§16363 and 16364 deal with the allocation of receipts from minerals and other natural resources, and receipts from timber, respectively. In some situations, these sections produced dramatically different results from the rules that had governed such receipts prior to the enactment of the UPIA. In the case of receipts from oil and gas and hard mineral leases, the old rules generally had the effect of allocating 85%-100% of receipts to income. The UPIA rules generally allocate 90% to principal and only 10% to income.

§§411 and 412 of the Uniform Act, from which §§16363 and 16364 were drawn, each contained a savings provision that permitted a trustee who was already administering any of the subject natural resources on the effective date of the new act to continue using whatever allocation rule the trustee had been using previously. Those savings provisions were inadvertently dropped from the UPIA when it was enacted.

The proposal would reinsert the grandfathering provisions from the Uniform Act that were inadvertently omitted from the UPIA.

##### Probate Code §16361

Probate Code §16361 was based on §409 of the Uniform Act, without substantive change.

Probate Code §16361 has been controversial since its enactment, because it contains a "90/10 rule" for allocation of distributions, including required minimum distributions, from retirement plans and accounts. Under that rule, 90% of each such distribution received by a trust is allocated to principal and only 10% to income. (This rule applies where the payer does not specify what portion of the payment represents income earned inside the plan or account, which is usually the case.) The 90/10 rule will frequently allocate much less to income than the account owner and the settlor of the trust likely intended.

Under this proposal, total distributions in any year from an IRA or other "individual account" would be allocated to income, to the extent that they did not exceed 4% of the total account value in any year. Any additional distributions would be allocated to principal. "Individual accounts" include IRAs and other arrangements where the trustee can identify the value of the participant's interest.

If payments are received from a source which is not an individual account, the proposal would retain the 90/10 rule.

This proposal is intended to alter the allocation between income and principal for distributions received from individual accounts to better reflect the expectations of settlors and beneficiaries of a trust when the trust is the beneficiary of an individual account.

A trust which receives distributions from an individual retirement account and is governed by Probate Code §16361 is unlikely to meet the standard set forth in the regulations under Internal Revenue Code §643 for determining the amount of income to be allocated between current and future trust beneficiaries. Under those regulations, the governing state's law definition of "income" will be respected if it provides "for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year." It is likely that the current 90/10 rule does not satisfy this standard, since there is no meaningful relationship between the required minimum distribution from a retirement plan and the amount of income generated by that plan. Thus, the trustee's allocation may not be a proper basis for calculating the trust's distributable net income under Internal Revenue Code §642. Although Probate Code §16361(d) states that the trustee shall allocate "the additional amount necessary" to obtain an estate marital deduction, the section does not specify how much more of the payment should be allocated to income. These issues will likely generate confusion and controversy among beneficiaries and trustees. This proposal will remedy both of these shortcomings.

#### Probate Code §16374.1

In the past, the income tax treatment of a trust and its income beneficiary was often straightforward. Interest, rents and dividends were distributed to the income beneficiary, and this distribution of "distributable net income" shifted the income tax burden for these items from the trust to the beneficiary. The income tax liability for capital gains was not passed out to the income beneficiary, since such gains were typically retained by the trust and primarily benefitted future beneficiaries.

Under the UPIA, income beneficiaries are more likely to receive distributions which are something other than the rent, interest and dividends received by the trustee (e.g., capital gains). Internal Revenue Code §664(b) provides an ordering rule for charitable remainder trusts, and the California Legislature recently enacted legislation, which will take effect on January 1, 2006, to authorize the conversion of "net income" trusts into non-charitable unitrusts (SB 754). SB 754 includes an ordering rule that specifies the income tax character of unitrust distributions received by beneficiaries. However, even though SB 754 has been enacted, there may be non-charitable unitrusts which will fall outside of its scope (e.g., trusts which were initially drafted as unitrusts, as distinguished from those that were converted from "net income" trusts into unitrusts). In addition, while a trustee's exercise of the adjustment power under Probate Code §16336 may cause something other than rent, interest and dividends to be included in distributable net income, the character of that income (e.g., short-term capital gain, long-term capital gain) is not specified in California law. A default ordering provision will cover these situations.

At present, current fiduciary accounting income that is required to be distributed to a current beneficiary is characterized as taxable income to that "tier 1" beneficiary. The general conduit and pro rata allocation rules of Internal Revenue Code §662(b) provide that other items retain their character and that the various items of taxable and non-taxable income (and gain if not excluded from distributable net income) are allocated in proportion to the relative amount distributed to or among the "tier 2" beneficiaries.

Unless the governing instrument or state law provides an ordering rule or the trustee adopts a "regular practice" of allocating capital gain to a current beneficiary to fund any difference between traditionally-defined fiduciary accounting income and the amount distributed to a current beneficiary, each current beneficiary of any trust who receives a distribution of anything other than current fiduciary accounting income during the tax year will be treated as a tier 2 beneficiary (as to that distribution). In most cases, recognized gain will be taxed to the trust and not the current beneficiaries.

The proposed ordering rule would characterize a distribution in excess of fiduciary accounting income first as capital gain (to the extent of gain recognized during that tax year) and cause it to be taxed to the beneficiary rather than the trust. Because a beneficiary may have losses that can be offset against gains and may be in a position to plan for the potential application of the alternative minimum tax and the impact of Internal Revenue Code §67's two percent "floor" for miscellaneous itemized deductions in a way that the trustee cannot, the allocation of gain to the current beneficiary will reduce the overall tax burden in many instances and will rarely, if ever, increase it.

Any discretion the trustee may exercise that determines the allocation of tax liability between current beneficiaries and the trust (or, more properly, current and future beneficiaries) provides the basis for controversy. By defining clear rules for trustees rather than having different rules for those who adopt a regular practice and those who do not, the potential for disharmony is reduced.

Moreover, taxing the beneficiaries of some trust relationships more heavily than others because of a trustee's adoption or failure to adopt a "regular practice" leads to inequity and the potential

for controversy. This may be particularly true for existing trust relationships, where the trustee may be precluded from adopting a regular practice because of actions taken without attention to new Treasury Regulation § 1.643. (In new relationships that arise after the effective date of the new regulation, trustees likely will be more sensitive to the consequence of the decision made during the first tax year in which any distribution in excess of traditionally-defined fiduciary income is made.)

The proposed scheme provides that distributions will carry out the following, in the following order: ordinary income, short-term capital gain, long-term capital gain, tax-free income and principal. The proposed ordering rule is similar to §664(b) of the Internal Revenue Code which applies to charitable split-interest trusts. The proposal is a default rule which can be overridden by the governing instrument or court order.

## **ILLUSTRATIONS:**

### Amendment to Probate Code §§16363, 16364

A trust holds an interest in a natural gas lease, and the trustee receives \$100,000 from this source. Prior to the UPIA, the trustee routinely allocated \$85,000 of this amount to the income beneficiary. However, with the adoption of the UPIA, Probate Code §16363 reduces the income beneficiary's portion to 10%, or \$10,000. The proposal would allow the trustee to continue to follow the former rule for this and any other natural resource asset acquired by the trust before January 1, 2000 (the effective date of the UPIA).

### Amendment to Probate Code §16361

A settlor creates a trust which provides that all trust income will be paid to his surviving spouse, and the settlor names the trust as the beneficiary of his IRA. When the settlor dies and the trust become irrevocable, the settlor's surviving spouse is 63 years old. Under the minimum distributions rules applicable to IRAs, the spouse's life expectancy is 22.7 years, and the minimum distribution from the IRA to the trust in the first year would be  $1/22.7$  of the value of the IRA. Applying the 90/10 rule, the amount distributed to the spouse as income would be less than one-half of one percent (.4%) of the value of the IRA. If, instead, the oldest beneficiary of the trust were a 20-year old grandchild, the income distributed to the grandchild the first year would be less than one-fifth of one percent (.16%) of the value of the IRA.

Under the proposed new rule, the entire distribution – up to 4% of the value of the account – would be income and the rest would be principal.

### Amendment to Probate Code §16340

A settlor creates a revocable trust which provides that upon her death, her friend shall receive \$100,000. The trustee does not pay this bequest for two years following the settlor's death. This proposal will ensure that the beneficiary will be entitled to statutory interest on the \$100,000 gift, beginning one year after the decedent's death.

## New Probate Code §16374.1

A trust instrument provides that the trustee has complete discretion to make distributions of income and principal to the current beneficiary. During the year, the trust earns \$100 of ordinary income, \$200 of short-term capital gain, \$500 of long term capital gain and \$300 of tax-exempt income. The trustee makes an adjustment under Probate Code §16336 and distributes \$500 as "income" to the beneficiary to provide for an equitable division of benefits between the current and future beneficiaries. The trustee's distribution will carry out all of the ordinary income (\$100), all of the short-term capital gain (\$200) and \$300 of the long-term capital gain to the beneficiary, who will include those items on his/her income tax return, and the trustee will deduct those amounts from the trust's income tax return.

**APPLICATION:** The proposed amendments and new section would apply to trusts which are governed by the UPIA and which do not include contrary provisions.

**DOCUMENTATION:** The author is not aware of any formal studies or documentation.

**HISTORY:** This amends Probate Code §§16340, 16361, 16363 and 16354, which became effective on January 1, 2000, through the enactment of AB 846 (Ackerman), Chapter 145, Statutes of 1999, a bill sponsored by the California Law Revision Commission (<http://clrc.ca.gov/pub/Printed-Reports/Pub202-UPAIA.pdf>) and adds new §16374.1.

**PENDING LITIGATION:** None known.

**LIKELY SUPPORT OR OPPOSITION:** The Committee believes that the proposed legislation will more than likely find support by professional and corporate trustees, as well as counsel for individual (non-professional) trustees.

**FISCAL IMPACT:** No anticipated fiscal impact.

**GERMANENESS:** Drafting a proposal such as this requires an understanding of the pertinent tax and accounting laws, as well as an appreciation of the interests of both trustees and trust beneficiaries. The members of the Trusts and Estates Executive Committee have interest and expertise in these areas.

## **TEXT OF PROPOSAL**

SECTION 1. Section 16340 of the Probate Code is amended to read:

16340. After the decedent's death, in the case of a decedent's estate, or after an income interest in a trust ends, the following rules apply:

(a) If property is specifically given to a beneficiary, by will or trust, the fiduciary of the estate or of the terminating income interest shall distribute the net income and principal receipts to the beneficiary who is to receive the property, subject to the following rules:

(1) The net income and principal receipts from the specifically given property are determined by including all of the amounts the fiduciary receives or pays with respect to the

property, whether the amounts accrued or became due before, on, or after the decedent's death or an income interest in a trust ends, and by making a reasonable provision for amounts the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

(2) The fiduciary may not reduce income and principal receipts from the specifically given property on account of a payment described in Section 16370 or 16371, to the extent that the will, the trust, or Section 12002 requires payment from other property or to the extent that the fiduciary recovers the payment from a third person.

(3) *A specific gift distributable under a trust carries with it income in the same manner as a specific devise under a will, as set forth in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7*

~~(b) The fiduciary shall distribute to a beneficiary who receives a pecuniary amount, whether outright or in trust, the interest or any other amount provided by the will, the trust, or Chapter 8 (commencing with Section 12000) of Part 10 of Division 7, from the remaining net income determined under subdivision (c) or from principal to the extent that net income is insufficient.~~ *A general pecuniary gift, an annuity, or a gift of maintenance distributable under a trust carries with it income and bears interest in the same manner as a general pecuniary devise, an annuity, or a gift of maintenance under a will, as set forth in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7. The fiduciary shall distribute to a beneficiary who receives a pecuniary amount, whether outright or in trust, the interest or any other amount provided by the will, the trust, this subdivision, or Chapter 8 (commencing with Section 12000) of Part 10 of Division 7, from the remaining net income determined under subdivision (c) or from principal to the extent that net income is insufficient.*

(c) The fiduciary shall determine the remaining net income of the decedent's estate or terminating income interest as provided in this chapter and by doing the following:

(1) Including in net income all income from property used to discharge liabilities.

(2) Paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries, court costs and other expenses of administration, and interest on death taxes, except that the fiduciary may pay these expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of these expenses from income will not cause the reduction or loss of the deduction.

(3) Paying from principal all other disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the trust, or Division 10 (commencing with Section 20100).

(d) After distributions required by subdivision (b), the fiduciary shall distribute the remaining net income determined under subdivision (c) in the manner provided in Section 16341 to all other beneficiaries.

(e) For purposes of this section, a reference in Chapter 8 (commencing with Section 12000) of Part 10 of Division 7 to the date of the testator's death means the date of the settlor's death or of the occurrence of some other event on which the distributee's right to receive the gift depends.

SEC. 2. Section 16361 of the Probate Code is amended to read:

~~16361.(a) In this section, "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit sharing, stock bonus, or stock ownership plan.~~

~~(b) — To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.~~

~~(c) — If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subdivision, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.~~

~~(d) — If, to obtain an estate tax marital deduction for a trust, a trustee shall allocate more of a payment to income than provided by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.~~

~~(e) — This section does not apply to payments to which Section 16362 applies.~~

~~(a) In this section, "payment" means:~~

~~(1) a payment that a trustee may receive over a fixed number of years or during the life of an individual because of services rendered or property transferred to the payer in exchange for future payments; and~~

~~(2) a payment that a trustee may receive pursuant to an income tax advantaged contractual, custodial, or trust arrangement, including but not limited to a private or commercial annuity, a pension or profit-sharing plan, an individual retirement account, Roth IRA, or any similar arrangement (regardless of whether the payment is made from an "entity" as defined in Section 16350).~~

~~(b) To the extent that a payment is characterized by the payer as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.~~

~~(c) If no part of a payment is characterized by the payer as interest, a dividend, or an equivalent payment, the trustee shall allocate the payment as follows:~~

~~(1) If the payment is received from an individual account, the trustee shall allocate the payment to income to the extent that the payment, when combined with all other payments received from such individual account during that same accounting period (the "cumulative amount received"), does not exceed four percent (4%) of the account value (the "income allocation amount"). To the extent that any portion of a payment causes the cumulative amount received to exceed the income allocation amount, such portion, together with all further amounts received from such individual account during that accounting period, shall be allocated to principal.~~

~~(A) As used in this section, the term "individual account" means an individual account~~



*plan as defined in the Employee Retirement Income Security Act of 1974, as amended from time to time, and any other plan, account, or arrangement whose terms enable the trustee to identify the fair market value of the participant's or owner's interest therein.*

*(B) As used in this section, the term "account value" means the fair market value of the individual account as of the later of the last day of the trust's preceding accounting period and the date when the right to receive payments from the individual account first became subject to the trust.*

*(C) Where an account period consists of less than 365 days, the income allocation amount shall be prorated on a daily basis.*

*(2) If the payment is received from a plan, account or other arrangement that is not an individual account, the trustee shall allocate the payment as follows:*

*(A) If all or part of the payment is required to be made to the trustee, the trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal.*

*(B) If no part of a payment is required to be made to the trustee or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal.*

*(C) A payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.*

*(d) If, to obtain an estate tax or gift tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.*

SEC. 3. Section 16363 of the Probate Code is amended to read:

16363. (a) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:

(1) If received as a nominal bonus, nominal delay rental, or nominal annual rent on a lease, a receipt shall be allocated to income.

(2) If received from a production payment, a receipt shall be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance shall be allocated to principal.

(3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, 90 percent shall be allocated to principal and the balance to income.

(4) If an amount is received from a working interest or any other interest in mineral or other natural resources not described in paragraph (1), (2), or (3), 90 percent of the net amount received shall be allocated to principal and the balance to income.

(b) An amount received on account of an interest in water that is renewable shall be allocated to income. If the water is not renewable, 90 percent of the amount shall be allocated to principal and the balance to income.

(c) This chapter applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

*(d) If a trust owns an interest in minerals, water, or other natural resources on January 1, 2000, the trustee may allocate receipts from the interest as provided in this chapter or in the manner reasonably used by the trustee before January 1, 2000. If the trustee acquires an interest in minerals, water, or other natural resources after January 1, 2000, the trustee shall*

*allocate receipts from the interest as provided in this chapter.*

SEC. 4. Section 16364 of the Probate Code is amended to read:

16364. (a) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts as follows:

(1) To income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest.

(2) To principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber.

(3) To or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2).

(4) To principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraph (1), (2), or (3).

(b) In determining net receipts to be allocated under subdivision (a), a trustee shall deduct and transfer to principal a reasonable amount for depletion.

(c) This chapter applies whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.

*(d) If a trust owns an interest in timberland on January 1, 2000, the trustee may allocate net receipts from the sale of timber and related products as provided in this chapter or in the manner reasonably used by the trustee before January 1, 2000. If the trustee acquires an interest in timberland after January 1, 2000, the trustee shall allocate net receipts from the sale of timber and related products as provided in this chapter.*

SEC. 5. Section 16374.1 is added to the Probate Code, to read:

16374.1. Unless otherwise provided by the governing instrument, determined by the trustee, or ordered by the court, distributions to beneficiaries shall be considered paid in the following order from the following sources:

*(a) From net taxable income other than capital gains.*

*(b) From net realized short-term capital gains.*

*(c) From net realized long-term capital gains.*

*(d) From tax-exempt and other income.*

*(e) From principal of the trust.*